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NSC FOR DAN FISK
COMMERCE FOR MSELIGMAN
STATE PASS USTR FOR AMALITO

E.O. 12958: DECL: 01/13/2032
TAGS: EPET EINV ENRG PREL BBSR NI VE HO
SUBJECT: HONDURAS EXPROPRIATES U.S. OIL COMPANIES' STORAGE FACILITIES

REF: TEGU 0076 AND PREVIOUS

Classified By: CDA James Williard for reasons 1.4 (b,d)

¶1. (S/NF) Summary: On January 13, the GOH announced in a surprise decision that it would be compelling use of privately-owned oil import and storage facilities in Honduras. It remains unclear which facilities are affected, but at a minimum Honduran firm DIPPSA and U.S. firm Esso are subject to the new decree. The language of the decree says the measures are "temporary" but GOH officials have said that the duration is "indefinite." The decree calls for just compensation, but that price is to be set by the GOH, and negotiations to lease some of those facilities had previously broken down when the GOH offered only half of what DIPPSA felt was a fair price. The GOH also unilaterally cut gasoline prices by up to USD 0.42, which would reportedly leave many importers selling below cost. Finally, the GOH has ordered a criminal investigation into the oil companies, charging them with economic sabotage for allegedly undersupplying the Honduran market with gasoline in order to create a fuel crisis. Both the private sector and Post are gravely concerned about both how these measures will be carried out and about the strongly negative message they send to current and potential investors. Oil company executives, meanwhile, have found it prudent to leave Honduras. End Summary.

¶2. (S/NF) Contrary to assurances given to Post on January 12 by GOH negotiator Arturo Corrales and assurances given by President Zelaya to Vice President Elvin Santos (and passed to Charge), the GOH Council of Ministers on January 13 decreed that the GOH would expropriate existing private sector oil offloading and storage facilities. The decree cites a clause in the contract between Honduran fuel importer DIPPSA and the GOH that reportedly permits the GOH to compel use of DIPPSA's storage facilities in times of national emergency. Because the joint-venture PetroSur facility (50 percent owned by Esso and 50 percent by DIPPSA) also falls under this agreement, Esso's facilities will be expropriated as well. Minister of the Presidency Yani Rosenthal confirmed

that Esso facilities would be covered by the decree, but opined that Texaco's (which reportedly do not have a similar clause) would not. However, in public statements Minister Counselor for Legal Affairs Enrique Flores Lanza said that the decree would cover all companies.

¶3. (U) The specific text of the decree (Article 2) reads as follows:

The Honduran state will exercise for the public benefit its contractual right to use the fuel storage terminals of the distribution companies now in the country, by means of payment of a just compensation. The Government guarantees to continue the process of the international solicitation for fuel imports with the company that presented the best offer.

(Note: The company referred to in the second sentence, the one that presented the best offer under the highly contentious bid solicitation process, was U.S. firm ConocoPhillips. Under that process, the GOH will nationalize all imports, and contract for a year's supply with a single fuel supplier. However, despite an apparent obligation to have done so by early January, the GOH and ConocoPhillips have not yet signed a contract. According to public remarks by Minister Flores Lanza, ConocoPhillips declined to sign any contract for delivery of fuel until the GOH could demonstrate it had storage capacity for those deliveries. This demand apparently triggered the GOH action to seize control of the private facilities owned by DIPPSA and Esso. End Note.)

¶4. (SBU) In addition to the expropriation, the decree also unilaterally lowers gasoline prices by up to eight lempiras (about USD 0.42) per gallon, citing declines in international

prices and "savings" from the fuel import solicitation process. Regarding the first of the two justifications, the GOH already sets all prices for gasoline, based on a formula that reacts to a 22-day rolling average of international prices. Under this arrangement, the GOH has the right to change prices, but the January 13 decree does so in a manner that violates all existing procedures and leaves the international oil companies (IOCs) with no effective guidance as to how to price their product. Given that the price changes were to take effect at 0600 on January 14, at least one company (Esso) said it might have to keep its stations closed until this matter is cleared up. The second justification for the price reduction is the illusory savings claimed by the GOH from the bid solicitation process, and is based on not counting a reported seven line-items of import costs, and then using the ConocoPhillips offer (still unsigned) as a baseline reference price. Minister Rosenthal said all of these price cuts would come from the importer's profit margins, and that the profit margins of the (Honduran) transporters and marketers would not be touched. According to rough calculations by Presidential negotiator for fuels Arturo Corrales, this means the IOCs are being instructed to sell their product below cost. In his January 13 public remarks, Rosenthal shrugged this off, noting that the IOCs could still make adequate profits in other segments of their value chain.

¶5. (C/NF) During the late night (2100 hours local) press conference, in which President Jose Manuel "Mel" Zelaya Rosales personally read the text of the Council of Ministers decree, Zelaya also said the GOH has instructed the prosecutor's office to initiate a criminal investigation of the IOCs to identify the cause of last week's alleged fuel shortages. As previously reported, those "shortages" were limited to a few gas stations and according to the companies involved were the result of a delayed tanker delivery. Reports of the alleged shortage prompted Zelaya on January 11 to label the IOCs "energy terrorists" and to call for the Council of Ministers meeting. Ironically, we are told a tanker was being unloaded even as the President made his remarks on January 11 denouncing the IOCs for refusing to

supply the Honduran market. As a result of that incident, the GOH reportedly issued an arrest warrant for the country representative for Royal-Dutch Shell Oil Company, accusing that the shortage was deliberate economic sabotage. In the wake of that (still unverified) report and the President's subsequent remarks of January 13, senior representatives of Shell and Texaco have already left Honduras, and representatives of Esso are strongly considering the same move.

¶6. (C/NF) EconChief spoke with several key actors immediately following the announced government takeover. All expressed shock and grave concern about this action. Their initial reactions follow:

-- Esso: Said its lawyers are looking at the specifics of the contract, since the GOH alleges the joint venture Esso/DIPPSA storage facility in San Lorenzo is covered by a clause in the DIPPSA contract that allows the GOH to compel use of the facilities. Esso also noted that the announced change in price for gasoline violates the current procedure for the GOH to announce price changes, and cannot be legally acted upon by the firm. Facing two contradictory decrees on pricing, Esso feels that it might need to keep its stations shut until the matter is resolved. Esso also noted its concern that the product (diesel and gasoline) currently in storage is property of the importing firms, and questions whether that product has also been seized. Finally, based on reported threats to arrest IOC executives for alleged economic sabotage, Esso is considering pulling its expatriate staff out of the country immediately.

-- Texaco: Texaco's country representative is already out of

Honduras, but EconChief reached him in El Salvador. He reports a lack of concrete information, noting in particular that it remains unclear whether the GOH action covers the Texaco offloading and storage facilities in Honduras. He felt the GOH likely to arrest IOC executives if given the chance, and therefore left Honduras following reports of such a warrant being issued against Shell executives.

-- DIPPSA: President of DIPPSA told EconChief that he was caught as much unawares as anyone by the sudden decision to take over his and other firms' facilities. He said he had come to no agreement with the GOH about this, was not previously informed about the action to come, and that he opposes it. DIPPSA had been in negotiations with the GOH to lease storage services to the GOH at a price of USD 0.065 per gallon of throughput. Talks stalled when the GOH had reportedly refused to pay more than USD 0.03. The next round of talks was scheduled for Monday, January 15. DIPPSA President Henry Arevalo told EconChief he will not violently resist the takeover of his facilities, but that he feels it is trespassing and illegal taking and that he will require the GOH to act. "If (the GOH) wants (my facilities) they have to come take it." (Note: Asked precisely how the GOH intended to take over the facilities and whether troops would be used, Minister Rosenthal told EconChief that the details have not yet been worked out. Similarly, the GOH does not know how or when it might compensate the rightful owners. The GOH still owes oil companies an estimated USD 10 to 15 million in reimbursements from the recent gasoline price freeze, in place from April through the autumn of 2006, that the GOH compelled the companies to absorb. End Note.)

-- Presidential negotiator Arturo Corrales: As reported previously, Corrales was dispatched (first quietly then officially) by Zelaya to negotiate with the IOCs. Zelaya continued to hope the IOCs would relent and allow use of their facilities; they did not do so. However, once changes to the pricing formula were put on the table as a topic for discussion, the IOCs were willing to work constructively with Corrales and the GOH to identify savings for the consumer and help the GOH find a face-saving exit to this

situation. Corrales reported progress in these talks as of January 12, and had scheduled another round of meetings for January 15-17 to move further towards a resolution. Moreover, this effort was being conducted in the context of a proposal for a broader move over the next 2-3 years towards a liberalized fuels market in Honduras, like those already in place in Salvador and Guatemala. Post was actively supporting such a dialogue, and had obtained agreement from the World Bank to use its good offices to host a neutral discussion of next steps towards liberalization. Nevertheless, a downbeat Corrales told EconChief on January 13 that he, too, had been shocked by the decision, and that he was trying to reach the President to discuss the matter. In Corrales' view, he had been dispatched to dialogue in good faith with the companies. The President's decision to expropriate undercut any progress Corrales had made and destroyed his credibility as an honest broker. Corrales understands the profound damage this decision is likely to do to Honduras' investment climate, but for the moment he appears to Post to be out of the decision-making loop.

-- Shell: Shell's fuel imports are delivered both independently and in conjunction with Texaco deliveries. EconChief could not reach Shell for comment, but other sources reported the following: Though some individual stations in San Pedro had run dry, Shell cited high gasoline sales over the heavily-traveled Christmas holiday and a minor shipping delay as the causes. Shell had already made arrangements with Texaco for additional shipments (which arrived on January 11) and was seeking GOH permission for overland imports from Salvador to resupply any service stations that had sold out of any product. Shell immediately publicly denied that there was a "shortage." Shell denied

any intentional undersupplying of the market. In the face of GOH threats to charge the company with economic sabotage, Shell representatives have reportedly left Honduras.

-- Honduran Private Sector: The President of the Honduran private sector umbrella organization COHEP, Mario Canahuati, contacted EconChief on January 13 as part of a late-night emergency conference call with the President of the Honduran Manufacturers Association Jesus Canahuati and others, to express their grave concern about this turn of events. Canahuati complained that far more than just a legal dispute with the IOCs, this expropriation will negatively impact investment inflows, could jeopardize Temporary Protected Status (TPS) renewal, and could by extension lead to slower growth, higher unemployment, more emigration, and higher rates of criminality in Honduras. EconChief noted that the USG will need to analyze events before taking a formal position, but that the reaction would be negative to some degree. In addition, affected firms retain their right to file lawsuits, and prospective investors are likely to be scared away by this turn of events, particularly when paired with Nicaraguan President Daniel Ortega's embrace (both literally and figuratively) this week of Chavez and his socialist ideals. EconChief said that it is far too early to speculate on the fate of TPS, but that most Members of the U.S. Congress likely know little about Honduras, and if their enduring image of Honduras is of a country that expropriates U.S. investor assets, that will certainly complicate any GOH effort to generate good will on the Hill.

-- President Zelaya: Post has not spoken directly with Zelaya yet, but his public remarks are instructive. In justifying the nationalization of all oil imports, the creation of a monopoly supplier, and the expropriation of U.S. and Honduran privately-owned storage facilities to accomplish this, Zelaya said, "We felt obligated to take these necessary measures for development, measures that increase confidence in investment, and that demonstrate this government has a pact with its people and with the productive sectors to find solutions. The Honduran public knows me, and my respect for foreign investment, and also my continuing

belief in property rights and especially in the rules of a free market, which make it possible for private enterprise to develop in this country in an atmosphere of free competition."

¶7. (C/NF) Comment: To say that the GOH has the right in a period of national emergency to compel use of private facilities seems to Post to do little more than reiterate a basic privilege that all governments claim -- that of exercising eminent domain if absolutely necessary. Therefore, a debate over whether the GOH has a legal right to expropriate seems misplaced. Nevertheless, how the GOH chooses to exercise this prerogative holds significant concerns for U.S. investors. These concerns include effective compensation; ownership of the current fuel inventory; contractual obligations downstream; safety and insurance related concerns; and the safety of company executives. To this list Post would add the strongly negative signal such a move sends to potential future investors. The GOH is saying, in essence, that if investors do not capitulate to GOH demands at the negotiating table, the GOH will simply take their investments over by force. Finally, given the legal and technical complexities involved, Post does not discount the possibility of fuel shortages over the coming weeks. Current importers have not said so, but it seems likely they will need to halt all imports for the time being, and no contracts (not to mention legal, financial, and logistical arrangements) yet exist with the new monopoly fuel provider, ConocoPhillips, for future fuel imports. Post assesses that other participants in the previous talks, including Corrales, were acting in good faith and were genuinely surprised by the President's somewhat capricious and certainly demagogic decision to expropriate. That Zelaya could then justify such an action as improving the investment

climate and defending property rights tells you all you need to know about the root cause of this disaster. End Comment.

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